**Brief on Interpretation of Financial Statement ratios**

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| Key points to be kept in mind while writing interpretation on financial ratios:  What ratios to be prepared be very clear  Whose purpose the ratios are being prepared be very clear  If, any underlying impacts are there such as   1. Disposed business during the year 2. Acquired business during the year 3. Assets held for sale during the year 4. Disposed assets during the year 5. Discontinued operations during the year 6. Major restructure during the year   please calculate the ratios based on removing those underlying impact to enable the comparability of current year ratios with previous year  These underlying impacts are one time impact, due to these impacts the ratios calculated cannot be compared with previous year  While comparing compare the underlying ratios with previous year ratio as well as ratios calculated based on current year reporting information with previous year and highlight why such difference is there  The most important ratios that are affected due to underlying are  1. ROCE  2. Net assets turnover ratio  3. Operating profit ratio  4. Gross profit ratio  **How to prepare interpretation report**   * First highlight importance of particular ratio * Identify difference between underlying with previous year and reporting with previous year * Express the difference in terms of percentage if possible * What factors contributed for increase or decrease of ratio based on the given scenario * Sometimes general observations can also be stated for increase or decrease or ratios | * What can be the adverse impact of such decrease or increase of ratios * How to overcome such adverse impact of such ratio   Normally analysis can be asked to prepare on these areas   * **Performance ratios** (profitability performance ratios such as : ROCE, Operating profit ratio, GP ratio, Net assets turnover ratio, NP ratio) * **Position ratios: (Financial position ratios such as** * Liquidity ratios (current ratio and quick ratio, Inventory days, Receivables days, payables days) * Gearing ratio such as debt equity ratio * Inventory ratios such as EPS, DPS, P/E etc and dividend yield   Maximum ratios that can be calculated in the exam may not exceed 8 to 12 ratios such as   1. ROCE 2. Operating profit ratio 3. Net assets turnover ratio 4. GP ratio 5. NP ratio 6. Current ratio 7. Quick ratio 8. Inventory days 9. Receivables days 10. Payable days 11. Gearing ratio 12. Interest coverage ratio   **While writing interpretation on Performance ratios Key points to cover**   * Specify whether turnover has been increased or decreased and what is the % of change   What are the reasons for increase or decrease of revenue   * Write ROCE is a prime ratio or key ratio from owners point of view   Comment on ROCE for increase or decrease by Identify reasons for increase or decrease such as acquiring new assets C/Y, disposal of assets c/y, assets held of sale in C/Y etc. | Identify changes in operating profit in the current year due to high cost of sales or high operating expenses such as administration or selling and distribution   * Explain what happened to Net assets turnover ratio, how much is the change in the ratio and what factors have caused for the change, look into turnover changes and capital employed changes, if it decreased then mention less efficient in utilising the assets if it increased then mention that asset utilising increased that contributed for more earnings * Comment on GP ratio, such as increase or decrease and % of increase or decrease   What are the reasons for changes in GP ratio  Identify from Income statement, sales changes, costs of goods changes and % of sales changes and % cost of goods changes  Last year COGS as % of sales and this year COGS as % of sales  Sales changes due to sales price, sales mix, sales volume  COGS changes due to material cost, inventory valuation, direct labour cost etc.   * Comment on NP ratio: increase or decrease what % of increase or decrease and reasons for increase or decrease such as changes in sales changes COGS, Changes in Operating expenses, changes in finance cost, changes in taxation etc. could be the reason   Verify these information from FS and comment or may be due to one of changes (underlying ) comment specifically.  **Give overall comment on performance ratios**  **Position ratios:**  **Liquidity ratios:**  These ratios explain short term liquidity position of business, if the business does not have short term liquidity then business may face cash crunch because of which business may not be able to meet its short term obligations such as payables, bank OD, other expenses etc. This may affect the dividend payment, interest payment etc.  **Current ratio:** This ratios explains the for every one $ of current liability how many $ current assets maintained by business Verify increase or decrease and what % of change  compare with ideal (2:1) or industry averages, what can be reasons for decrease particularly, low inventory maintenance, low cash balance, low receivables | compared to high payables, high bank overdraft, other obligations etc.  **Quick ratio:** This ratios explains the for every one $ of current liability how many $ quick assets maintained by business. Quick assets are current assets less inventory. Inventory is excluded due to difficult to convert into cash easily.  Verify if inventory increases in the current year comment specifically the disadvantages of increase of inventory, low inventory comment that business is loosing profitability  Comment on Receivables if increase what are the disadvantages such as increase in bad debts, collection costs, administration costs, to reduce the receivables company need to change the credit policy such as credit period and credit amount and review the customers credit  **Inventory days:** comment specifically for increase or decrease these days due to ….particularly adverse impact  **Receivables days :** comment specifically for increase or decrease these days due to … particularly adverse impact  **Payable days :** Comment specifically for increase or decrease these days due to … particularly adverse impact.  **Gearing ratios:** This ratios explains the relationship between debt and equity or debt and debt + equity.  **This ratios explains the financial risk of the business**  Business has inherent business risk however, along with business risk if business hold high borrowings, it leads to high financial risk. Both should not be high it may lead to insolvency if the business is unprofitable.  Because of high financial risk it may affect the profits due to high interest cost.  In case of low debt equity then comment that the business is unable to increase the return to owners though it is good from risk point of view but it is not good from return point of view. Hence there must be balanced debt equity need to be maintained.  **Interest coverage ratio**: This is link to gearing ratio, comment on increase or decrease of interest coverage ratio. If it increases mention that is good for business may be due to decrease in debt, reduces financial risk and increase in operating profit verify the figures from FS  If decreases verify debt increased or operating profit decrease  **Give overall comment on position ratios**  **Provide overall comment on both together at the end.**  **Additional Information:** Sometimes they may ask additional information required for better analysis. Based on Scenario what further information is required need to be identified such as: audited financial statements, market share; product details, share holding pattern, market price of shares; budgets, management structure etc. |